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Nos. 06-1457 and 06-1462

In the Supreme Court of the United States

MORGAN STANLEY CAPITAL GROUP INC., *PETITIONER*,

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY, WASHINGTON, *ET AL.*, *RESPONDENTS*.

CALPINE ENERGY SERVICES, L.P., *ET AL.*, *PETITIONERS*,

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY, WASHINGTON, *ET AL.*, *RESPONDENTS*.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR RESPONDENTS PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY, WASHINGTON; NEVADA POWER COMPANY; SIERRA PACIFIC POWER COMPANY; AND OFFICE OF THE NEVADA ATTORNEY GENERAL, BUREAU OF CONSUMER PROTECTION

RICHARD G. TARANTO
FARR & TARANTO
1220 19th Street, N.W.
Washington, DC 20036
Counsel for Nevada Power Co. and Sierra Pacific Power Co.

CHRISTOPHER J. WRIGHT*
HARRIS, WILTSHIRE & GRANNIS LLP
1200 18th Street, N.W.
Washington, DC 20036
(202) 730-1300
Counsel for Snohomish County PUD No. 1

* *COUNSEL OF RECORD*

[Additional counsel listed on inside front cover]

PAUL J. KALETA
NEVADA POWER COMPANY
6226 West Sahara Ave.
Las Vegas, NV 89151

ROGER BERLINER
BERLINER LAW PLLC
700 12th Street, N.W.
Washington, DC 20005
Counsel for Nevada Power Co. and Sierra Pacific Power Co.

ERIC P. WITKOSKI
OFFICE OF THE NEVADA ATTORNEY GENERAL
BUREAU OF CONSUMER PROTECTION
555 E. Washington Ave. #3900
Las Vegas, NV 89101

ERIC CHRISTENSEN
SNOHOMISH COUNTY PUD NO. 1
2320 California Street
Everett, WA 98201

JOHN E. MCCAFFREY
DAVID D'ALESSANDRO
KELLY A. DALY
STINSON MORRISON HECKER LLP
1150 18th Street, N.W.
Washington, DC 20036
Counsel for the Office of the Nevada Attorney General Bureau of Consumer Protection

PARTIES TO THE PROCEEDING

Petitioner Calpine, in No. 06-1462, has settled its dispute with the Nevada companies, and FERC recently approved the settlement. 121 FERC ¶ 61,305 (Dec. 28, 2007). The dispute between the other petitioners on Calpine's brief, No. 06-1462, and the Nevada companies remains a live one.

RULE 29.6 STATEMENT

The disclosure statements of Public Utility District No. 1 of Snohomish County, Washington; Nevada Power Company; Sierra Pacific Power Company; and Office of the Nevada Attorney General, Bureau of Consumer Protection are included in their brief in opposition to the petitions for writs of certiorari. Those statements remain accurate.

QUESTION PRESENTED

Whether the Federal Energy Regulatory Commission acted unlawfully when, in response to complaints filed under Section 206 of the Federal Power Act, 16 U.S.C. § 824e, it refused to determine whether the rates and other terms in long-term contracts that were artificially inflated because of the western energy crisis of 2000-2001 were "unjust, unreasonable, unduly discriminatory, or preferential," as the statute requires.

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STATEMENT OF THE CASE

"The primary aim" of the Federal Power Act ("FPA") is "to protect consumers against exploitation at the hands of" sellers. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 610 (1944).[1] At the "heart" of the FPA lies the requirement that all rates and terms in covered energy contracts be "just and reasonable," *id.* at 611, and the statute commands FERC to correct rates that violate that standard. But FERC here refused to apply that standard. Accordingly, the Ninth Circuit held that FERC had misconstrued the statute and this Court's decisions in rejecting challenges to contracts executed during the western energy crisis of 2000-2001, and it remanded for further FERC review.

During the 2000-2001 crisis, sellers, including Enron and certain of the petitioners, inflated prices by manipulating power supplies and "gaming" the regulatory system governing rates. Petitioners entered into contracts with companies such as respondent Public Utility District No. 1 of Snohomish County, Washington ("Snohomish"), and Nevada Power and Sierra Pacific ("Nevada companies"), which purchase energy and provide it to consumers. All the prices available in the market were grossly inflated by manipulation and gaming. The crisis was so dire that Professor Alfred Kahn and other noted deregulation proponents urged imposition of price caps and other regulatory

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[1] This Court's decisions cite cases construing parallel provisions of the FPA and Natural Gas Act ("NGA") "interchangeably." *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 577 n.7 (1981) ("*Arkla*").

measures. ER896-ER898. FERC finally did so, and the crisis abated. Only later did the full extent of the manipulation and gaming come to light.

When respondents filed complaints with FERC, the agency refused to determine whether the rates and terms of the contracts executed during the crisis were just and reasonable from their inception. FERC expressly deemed that inquiry legally *irrelevant*, saying that the inquiry "would be relevant to contract modification only where there is a 'just and reasonable' standard of review." JA1275a. In FERC's view, this Court's decisions in *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956) ("*Sierra*"), and *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956) ("*Mobile*"), prohibit "just and reasonable" review and require a much more stringent "public interest" standard of review. *E.g.*, JA1275a-JA1276a, JA1560a-JA1561a, JA1564a, JA1567a.

The court of appeals held that FERC misread *Mobile* and *Sierra* as displacing the statute's "just and reasonable" standard. Pet. App. 3a-4a, 35a-36a.[2] The court held, moreover, that any presumption that certain contract rates are just and reasonable cannot reasonably apply unless (a) the contracts were executed "in a functional marketplace such that we may presume the contracted rates were originally just and reasonable," and (b) FERC's reliance on a blanket advance authorization of *sellers* to make contracts was coupled with a timely opportunity for challenge and correction of the *contracts*. *Id.* at 41a-42a. The court also held that FERC had erred by

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[2] References to "Pet. App." are to the appendix in No. 06-1457.

focusing its analysis of whether the challenged contract rates are too high on three factors mentioned in *Sierra* for judging whether presumptively valid contract rates are *too low*. *Id.* at 60a-61a. The court remanded the case for FERC to reexamine it under the appropriate standards.

A. The Federal Power Act

The FPA is intended "to protect power consumers against excessive prices." *Pennsylvania Water & Power Co. v. FPC*, 343 U.S. 414, 418 (1952). To this end, Congress mandated that "[a]ll rates and charges" demanded by a regulated utility "shall be just and reasonable," and stated unequivocally that "any such rate or charge that is not just and reasonable is hereby declared to be unlawful." 16 U.S.C. § 824d(a).

To protect electric consumers from excessive rates, Congress provided FERC with two primary tools. The first, Section 205, requires that "every public utility shall file with the Commission ... schedules showing all rates and charges" for jurisdictional sales, "together with all contracts which in any manner affect or relate to such rates [or] charges," 16 U.S.C. § 824d(c); bars changes without at least 60 days' notice to FERC and the public, 16 U.S.C. § 824d(d); and empowers FERC to suspend the schedule, to hold a hearing on its lawfulness, to change the schedule, and, if it has taken effect, to order refunds. 16 U.S.C. § 824d(e).

The second tool, Section 206, requires FERC, *sua sponte* or upon complaint, to determine whether an existing rate is unjust or unreasonable and, if so, to correct it. Specifically, Section 206(a) requires that,

"[w]henever the Commission ... shall find ... any rate, charge, or classification" demanded by a regulated entity, including any "contract affecting such rate, charge, or classification," to be "unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate ... or contract to be thereafter observed ... and shall fix the same by order." 16 U.S.C. § 824e(a).

B. *Mobile* and *Sierra*

In *Mobile* and *Sierra*, the Court reviewed unilateral attempts by sellers to increase contract rates. The Court held that the NGA and FPA do not authorize sellers to unilaterally repudiate contracts (*Mobile*) and do not allow FERC to *increase* contract rates, to benefit a seller, absent a demonstrated benefit to the consumers the statutes protect (*Sierra*). Contrary to FERC's view expressed in the orders now under review, these narrow decisions did not create a non-statutory, practically insurmountable standard for reviewing every contract.

In *Mobile*, a pipeline agreed to provide gas to a municipality at a fixed low rate for 15 years and, based upon that promise, a cement company agreed to construct a plant in the municipality. The contract was filed with the Commission "and, with the approval of the Commission, became part of" the pipeline's filed rates and contracts. 350 U.S. at 336. But, before the contract had run its course, the pipeline filed a new rate with the Commission under § 4(a) of the NGA, and claimed the right through this unilateral filing to increase the contract rate nearly 50%. Asking whether "a regulated natural gas

company furnishing gas to a distributing company under a long-term contract may ... change the rate specified in the contract simply by filing a new rate" under NGA § 4, 350 U.S. at 333-34, this Court answered no because "the Natural Gas Act does not give natural gas companies the right to change their rate contracts by their own unilateral action" of filing new tariff rates. *Id.* at 337.

The Court, following the plain language of Section 4(d) of the NGA—the statutory sibling of FPA Section 205—explained that the provision "[o]n its face" says "only that a change [to a rate] cannot be made without the proper notice to the Commission." 350 U.S. at 339. Section 4(d) is a filing *requirement*, not an *authorization* for rates ("simply a prohibition, not a grant of power"), and so could not be invoked to override contracts. *Id.*

In so reading Section 4(d), the Court said nothing to immunize contract rates from Section 4(a)'s blanket requirement that all rates be just and reasonable. To the contrary, the Court was at pains to stress that NGA § 5(a), the analog of FPA § 206, establishes "the basic power of the Commission" to "set aside and modify any rate or contract which it determines ... to be 'unjust, unreasonable, unduly discriminatory, or preferential,'" a power that applies to "*all* the rates" of a regulated company. 350 U.S. at 341 (quoting NGA § 5(a)) (emphasis in original). Thus, NGA §§ 4 and 5 together allow rates to be established initially by contract while ensuring that "*all* rates are subject to being modified by the Commission upon a finding that they are unlawful." 350 U.S. at 341 (emphasis added).

Whereas *Mobile* involved *only* the issue of modification by unilateral rate filing, *Sierra* involved a Commission-modification issue under FPA § 206. The Court made clear that the statute protects the "public interest" of electric consumers in low rates, as distinguished from the "private interest" of regulated utilities. 350 U.S. at 355. *Sierra*, like *Mobile*, involved bait-and-switch tactics of a regulated seller. To "forestall the potential competition" from the Bureau of Reclamation's Shasta Dam, the electricity seller entered into "a 15-year contract for power at a special low rate," which was "duly filed" with the Commission. 350 U.S. at 352. But five years later, "when power from Shasta Dam was no longer available," the seller filed a new rate schedule under FPA § 205 to increase the rate by 28%. *Id.*

After ruling, as in *Mobile*, that the unilateral rate filing was ineffective to change the contract rate, 350 U.S. at 352-53, the Court noted that the Commission had arguably followed FPA § 206 hearing procedures and addressed whether the Commission's decision supported "a finding that the existing rate is 'unjust, unreasonable, unduly discriminatory or preferential,'" the "condition precedent" to rate adjustment under Section 206. 350 U.S. at 353. The Court said no, holding that the Commission's finding that the contract rate "yields less than a fair return on the net invested capital" was not enough, without more, to deem the contract rate unreasonably low. *Id.* at 355. Because the FPA's purpose is "the protection of the public interest, as distinguished from the private interests of the utilities," this Court concluded, "a contract may not be said to be either 'unjust' or 'unreasonable' simply because it is unprofitable to the public utility." *Id.* Rather, where

a selling utility claims a contract rate is unlawfully *low*, "the sole concern of the Commission" is whether the low rate somehow threatens the "public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." *Id.* As the three examples make clear, a contract rate can be unlawfully *low* only if it causes the harms (excessive rates, discrimination, unavailability of service) to *buyers* the Act is designed to prevent.

Mobile and *Sierra*, then, are straightforward statutory interpretation cases following the maxim that a statute should be interpreted consistent with "the provisions of the whole law, and ... its object and policy." *John Hancock Mut. Life Ins. Co. v. Harris Trust and Sav. Bank,* 510 U.S. 86, 94-95 (1993); *NAACP v. FPC,* 425 U.S. 662, 669-70 (1976). *Mobile* and *Sierra* hold that a seller may not increase its filed-contract rates by a unilateral new filing and that Commission raising of contract rates must be grounded, not in the seller's profit interest, but in the *public* interest as defined by Congress—to "underwrit[e] just and reasonable rates to the consumers" of natural gas and electricity, so as "to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." *Atlantic Ref. Co. v. Pub. Serv. Comm'n,* 360 U.S. 378, 388 (1959).

C. FERC's Market-Based Regulatory Regime

FERC and its predecessor, the Federal Power Commission, before the 1990s followed the traditional regime contemplated by Congress in enacting the FPA in 1935: sellers filed tariffs before

charging the specified rates, which were subject to disapproval if not just and reasonable based on a direct inquiry into the cost of providing the service (including the costs of raising needed capital). In the 1990s, FERC moved toward a new "market-based" regulatory regime that has two relevant features. First, rather than making direct cost inquiries, FERC assumed generally that "[t]he availability of genuine alternatives provides a sufficient basis ... to conclude that 'market discipline' will be sufficient to keep the prices that sellers charge within the statutorily-prescribed just and reasonable zone." JA1566a (citation omitted). Second, FERC greatly relaxed rate-filing requirements. No longer requiring that particular *rates* even be filed, let alone open for review, before they take effect, FERC granted sellers "market-based rate authority" if the individual seller lacked market power or mitigated its ability to exercise market power. A seller with such authority may set rates by contract and report transactions only after the fact, in quarterly filings. *See California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1009 (9th Cir. 2004), *cert. denied*, 127 S. Ct. 2972 (2007) ("*Lockyer*").

This regime hardly abandoned the bedrock concept that rates, to be just and reasonable, must not significantly exceed cost (properly defined), *see* Stephen Breyer, *Regulation and Its Reform* 37-38 (1982), but relied on the market, rather than direct cost inquiries, to produce the desired result, *see Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993) (decision upholding regime because competition can keep prices close to costs); Pet. App. 16a. Reliance on markets, of course, can avoid administrative and other problems with cost-of-

service regulation. *See, e.g.*, Stephen Breyer, *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform*, 92 Harv. L. Rev. 549, 562-65 (1979). But the essential premise for markets "'to assure a "just and reasonable" result'" is that they be properly "competitive." *Consumers Energy Co. v. FERC*, 367 F.3d 915, 922-23 (D.C. Cir. 2004) (per Roberts, J.) (quoted in FERC Br. 27).

A critical prerequisite of FERC's new regime—articulated in numerous decisions and freely acknowledged by FERC itself—was ongoing oversight of the market and resulting rates. Every court to examine FERC's market-based regulatory regime has concluded that FERC may rely on market forces to produce just and reasonable rates *only if* FERC intervenes to correct market failures. *See, e.g.*, *Lockyer*, 383 F.3d at 1014-15; *Elizabethtown Gas*, 10 F.3d at 871; *Louisiana Energy & Power Auth. v. FERC*, 141 F.3d 364, 369-71 (D.C. Cir. 1998) ("*LEPA*"). *See also, e.g.*, *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Services*, 93 FERC ¶ 61,294 at 61,996-98 (2000) ("if over time rates do not behave as expected in a competitive market, the Commission must step in to correct the situation"); *San Diego Gas & Elec. Co. v. Sellers of Energy*, 95 FERC ¶ 61,418 at 62,559 (2001).

D. The Western Energy Crisis

This case arises from what FERC (Br. 16-17) concedes was "the worst electricity market crisis in American history"—when Western energy markets were "subjected to artificial manipulation on a massive scale." *Lockyer*, 383 F.3d at 1014-15. Generators manipulated prices "by withholding

power from the market to create scarcity and then demanding extremely high prices when scarcity was probable," while "traders engaged in anomalous bidding practices" designed to drive up the price of electricity. *Pub. Utils. Comm'n of California v. FERC*, 462 F.3d 1027, 1039 (9th Cir. 2006) ("*CPUC*"). In particular, Enron, originally a party to these proceedings, "gamed the California markets with impunity, using manipulative corporate strategies" that "artificially and fraudulently" created the appearance of market demand and transmission congestion. *Id.* at 1040.

Manipulation and Gaming. After investigating the crisis for more than a year, FERC staff concluded in March 2003: "The preponderance of evidence reviewed by Staff during this investigation indicates that Enron and its affiliates intentionally engaged in a variety of market manipulation schemes that had profound adverse impacts on market outcomes." JA209sa. FERC itself later concluded that these manipulation schemes were an exercise of "unmitigated market power in the form of gaming through multiple inappropriate trading strategies," which constituted "not only exploitation, but also abuse, overreaching, and gouging." *Enron Power Mktg., Inc.*, 106 FERC ¶ 61,024 at ¶¶ 26, 29 (2004). Indeed, FERC concluded that such abuses

> undermine[] the functioning of the wholesale power market and our reliance on that market to ensure that rates are just and reasonable.

Id. ¶ 9.

The abuses were not limited to Enron, but included many of the petitioners and their

supporting amici in this Court. The FERC Staff Report found evidence that Morgan Stanley Capital Group ("Morgan Stanley" or "MSCG"), American Electric Power ("AEP"), and Mirant, as well as Coral Power, Powerex, Dynegy, and Sempra, among others, were involved in Enron-style manipulation of the western markets. JA225sa-JA227sa, JA235sa-JA237sa, JA240sa-JA245sa, JA247sa, JA252sa, JA256sa-JA263sa, JA275sa-JA279sa. FERC itself charged them with violations, charges they settled.[3] Other evidence in the present proceedings, Record No. 1602[4] at 38-39; Record No. 1595 at 14-15, implicates major generators including Mirant and Dynegy in "shutting down power plants when electric demand was high in order to destabilize the electric grid, and to increase prices." *CPUC*, 462 F.3d at 1039.

While electricity markets were being manipulated, the FERC Staff reported, the western natural gas markets were also being manipulated, through churning, false price reporting, and other schemes, JA53sa-JA168sa, producing gas prices

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[3] *E.g.*, *Morgan Stanley Capital Group*, 105 FERC ¶ 63,028 (2003); *Am. Elec. Power Service Corp.*, 103 FERC ¶ 61,345, *reh'g denied*, 106 FERC ¶ 61,020 (2004); *Am. Elec. Power Service Corp.*, 106 FERC ¶ 61,025 (2004); *Mirant Ams. Energy Mktg.*, 111 FERC ¶ 61,488 (2005); *Coral Power*, 108 FERC ¶ 61,115 (2004); *Dynegy Power Mktg.*, 108 FERC ¶ 61,145 (2004); *Sempra Energy Trading Corp.*, 108 FERC ¶ 61,114 (2004); *Powerex Corp.*, 106 FERC ¶ 61,304 (2004).

[4] Citations to the Record are to Record Item Numbers in the Certified Index to the Record as designated by FERC pursuant to 28 U.S.C. § 2112 and 16 U.S.C. § 825*l*(b). FERC's Certified Index to the Record is reproduced in Volume VII of the Joint Excerpts of Record in the court of appeals.

"that would never have been sustained in a competitive market." JA24sa. Because natural gas is a critical fuel for electric generation, western natural gas and electricity markets are "inextricably linked," and the "dysfunctions in each fed off one another during the crisis." JA17sa. Petitioners AEP and Calpine, as well as Mirant (a respondent supporting petitioners), have all paid fines to the Commodities Futures Trading Commission for violations related to manipulation of natural gas prices, as have amici Coral and Dynegy.[5] *See also* JA117sa-JA122sa (noting AEP and Dynegy admissions of false reporting of natural gas prices); Record No. 1602 at 57.

This wave of misconduct contributed to unprecedented increases in electricity prices. In the Pacific Northwest, where prices historically averaged approximately $24 per megawatt-hour (MWh), prices in May 2000 suddenly and unexpectedly rose to $300 to $500 per MWh, and in December 2000, they spiked at $3500 per MWh, nearly 150 times the historical average. Between summer 1999 and summer 2000, buyers' expenditures for wholesale electricity in California more than quadrupled (from $2.04 billion to $8.98 billion), and a University of California study attributed 59% of the increase to the exercise of market power. ER1045-ER1046.[6] FERC

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[5] *In re Dynegy Mktg. & Trade*, CFTC Docket No. 03-03 (Dec. 18, 2002); *CFTC v. Am. Elec. Power Co.*, No. C2 03 891 (S.D. Ohio Sept. 30, 2003); *In re Calpine Energy Servs., L.P.*, CFTC Docket No. 04-11 (Jan. 28, 2004); *In re Coral Energy Res., L.P.*, CFTC Docket No. 04-21 (July 28, 2004); *In re Mirant*, CFTC Docket No. 05-05 (Dec. 6, 2004).

[6] "ER" refers to the Joint Excerpts of Record in the Ninth Circuit.

Staff concluded that spot electricity prices were 100 to 200 percent above competitive levels. JA205sa.

The crisis produced profound distortions of the forward markets at issue here. According to the FERC Staff Report, "spot power prices influence forward power prices in a statistically significant and economically important way," JA201sa, and "the trauma of dysfunctional spot power prices [during the crisis] so influenced buyers that they placed great weight on these prices in forming future expectations," JA25sa. The relationship was much greater than FERC Staff had anticipated because the "trauma" of the crisis caused *then-current* spot market prices to disproportionately sway expectations about *future* prices, and prices in forward markets—to which FERC began to direct buyers and sellers—shot up. *See* ER1210. Some sellers deliberately "sought to spike real time [spot market] prices in order to boost prices they would receive for longer term forward contracts." *See* Cal. Indep. Sys. Operator Corp.'s Responsive Filing to Certain Submissions Filed on 3/3/03, Ex. ISO-1 at 30 (filed Mar. 20, 2003), *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Services*, FERC Docket No. EL00-95-075.

Stanford energy economist Dr. Frank Wolak in an independent study concluded that "suppliers to California were able to exercise market power at unprecedented levels," producing "prices vastly in excess of competitive levels during the period May 2000 to June 2001." ER193-ER195. Those manipulated prices were "'preserved in long-term contracts signed in the Spring of 2001.'" ER1045-ER1046 (quoting Anjali Sheffrin, *California Power*

Crisis: Failure of Market Design or Regulation?, IEE Power Engineering Review, August 2002, at 8).

The Regulatory Contribution to the Crisis. While FERC moved forward with market-based regulatory changes, certain States experimented with deregulation at the retail level. California's experiment, in particular, set the stage for the 2000-2001 crisis. California forced separation of generation and distribution and effectively required local retailers to rely on spot markets, barring contracting in forward markets, for most of their needs. Pet. App. 19a-20a, 23a-24a. This regime was profoundly flawed. *See CPUC*, 462 F.3d at 1037-40.

In 2000, "something happened on the way to the trading forum, and the best laid regulatory plans went astray.... Old assumptions, based on antitrust theory, that market power could not be exercised by those who possessed less than 20% of the market share proved inaccurate." *CPUC*, 462 F.3d at 1039; Record No. 1602 at 59-65. While western energy markets spun out of control, FERC "abdicat[ed] its regulatory responsibility." *Lockyer*, 383 F.3d at 1014-15. One reason was that "non-compliance with FERC's [quarterly transactional] reporting requirements was rampant," so that FERC lacked "the transaction-specific data through which the agency at least theoretically could have monitored" the market for needed intervention. *Id.* at 1014. "[F]or all practical purposes," regulation was "non-existent while energy prices skyrocketed and rolling brownouts threatened California's businesses and citizens." *Id.*; *see* Frank A. Wolak, *Diagnosing the California Electricity Crisis*, Electricity Journal, Aug./Sept. 2003, at 12 (FERC's actions "allowed a

manageable problem to develop into an economic disaster").

By December 15, 2000, FERC concluded that there was "no assurance that rates will not be excessive relative to ... competitive market prices," and that "unjust and unreasonable rates ... could continue to be charged unless remedies are implemented." *San Diego Gas & Elec.*, 93 FERC ¶ 61,294 at 61,999. As its 'fundamental remedy," FERC disapproved California's limitations on forward purchases for load-serving utilities and "strongly urg[ed]" such retailers to enter into contracts of two years or more. *Id.* at 61,992-93. Recognizing that suddenly thrusting a huge demand onto the forward markets was likely to create a strong seller's market, FERC committed itself to "vigilant[ly] monitor" the long-term markets and to "address concerns about potentially unjust and unreasonable rates in the long-term markets" in future complaint cases. *Id.* at 61,994. As it turned out, even when rates significantly exceeded the $74/MWh benchmark rate FERC identified, *id.*, FERC did none of this.

On May 25, 2001, after a full year of the crisis, ten prominent economists, including Alfred Kahn, the intellectual father of deregulation, wrote the President and Congress expressing their "deep concern about the failure of [FERC] to act effectively to enforce the provisions of the Federal Power Act that require it to set just and reasonable wholesales prices for electricity in California." ER896. They explained the elementary point: "We cannot expect a market to operate to benefit consumers or for the resulting wholesale prices to satisfy the

requirements of the Federal Power Act if effective competition does not exist." ER897. And they concluded that the western energy markets "are not characterized by effective competition." *Id.* The economists concluded that FERC should "implement market-rule changes that guarantee wholesale prices in California are just and reasonable." *Id.*

The crisis did not abate until June 2001, when FERC imposed around-the-clock price caps on the spot market throughout the western United States and a "must-offer" requirement on generators so that they could not withhold power to create artificial scarcity. *See San Diego Gas & Elec.*, 95 FERC ¶ 61,418. Both spot and forward prices quickly dropped back to ordinary levels, *Am. Elec. Power Service Corp.*, 103 FERC ¶ 61,345 at ¶ 41 n.56; ER878-ER879, thus confirming that the markets previously had been manipulated. *See* ER1026-ER1029; see also FERC Br. 9-10 (acknowledging that "as a result" of regulatory action and other factors, "by early June 2001, prices in California spot and forward markets fell back to preexisting competitive levels"). Although FERC rejected requests to implement market-wide relief in the forward contract markets, it indicated that concerns about unjust and unreasonable bilateral contracts should be addressed through Section 206 complaint filings. *See San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Services*, 96 FERC ¶ 61,120 at 61,515, n.59 (2001).

E. The Transactions at Issue

Amidst this market "meltdown," *San Diego Gas & Elec. Co. v. Sellers of Energy*, 105 FERC ¶ 61,066 at ¶ 42 (2003), respondents Snohomish, the Nevada

companies, and Golden State Water Company ("Golden State")[7] (collectively, "Western Utilities") faced the mandatory statutory responsibility to acquire power to serve the growing needs of their customers. *E.g.*, Nev. Rev. Stat. § 704.040.

With its customers' demand forecast to increase by approximately 100 MW during 2001, Snohomish in December 2000 issued a Request for Proposals ("RFP") to acquire 75-100 MW for periods of up to three years. Snohomish provided the RFP to the 17 creditworthy suppliers it could identify then operating in the Pacific Northwest, but received only three bids meeting its needs, including one from petitioner, Morgan Stanley. Each supplier refused to offer more than 25 MW.[8]

Although Snohomish in December 2000 enacted a 35% rate increase, one of the largest in its history, to pay for these three contracts, the bids it initially received far exceed what even this rate increase could cover. In addition, although the RFP required the suppliers to hold their offers open for five business days, all three suppliers continually raised their offer prices throughout the week in which contracts were negotiated. ER829. Morgan Stanley unilaterally increased its offer price to Snohomish six times, sometimes within hours of the previous increase.[9] Moreover, the price increases were

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[7] The facts relating to Golden State—previously called Southern California Water—are discussed in its separate brief.

[8] The other two suppliers were petitioner AEP and Enron Power Marketing, Inc. Snohomish has now settled litigation arising from both of those contracts.

[9] ER859-ER874; *see also* ER828-ER832.

substantial, rising to levels as high as $333/MWh.[10] With the just-imposed retail-rate increase and yet another increase (perhaps over 100%) scheduled for October 2001 to reflect crisis-induced increases in prices from the Bonneville Power Administration, ER814-ER816, "*the only way* for [Snohomish] to lower the price it had to pay for a forward contract was to increase the duration of the contract," effectively forcing Snohomish, as Dr. Wolak observed, to "pay[] for market power on the installment plan." ER195 (emphasis added). In the end, Snohomish agreed to a nine-year contract at the unheard-of price of $105/MWh. *See* ER819.

Because of crisis-induced increases in its wholesale power costs, Snohomish had to increase its retail rates by nearly 60%, ER817-ER818, with the Morgan Stanley contract by itself accounting for almost one-sixth of that increase and expected to cause Snohomish a net loss of approximately $153 million over the life of the contract. ER832, ER837.[11] These rate increases are entirely attributable to

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[10] ER873.

[11] Petitioners (MSCG Br. 3) and FERC (Br. 12) assert that Snohomish made a profit by reselling Morgan Stanley's overpriced power at market prices that were even more inflated. But FERC requires a "life of the contract" analysis, *e.g., Northern Virginia Elec. Coop., Inc. v. Old Dominion Elec. Coop.*, 116 FERC ¶ 61,173 at ¶ 12 & n.11 (2006), and Snohomish will lose approximately $153 million over the life of the contract. ER832. Moreover, the contrary claim rests on the erroneous factual assumption that Snohomish was obtaining power under the contract from the beginning of 2001; in fact, Morgan Stanley's deliveries did not begin until April 2001, less than three months before FERC's intervention brought market prices under control. ER837.

crisis-induced inflation in Snohomish's power supply costs, as Snohomish held its non-power costs steady throughout the relevant period. ER822.

Similarly, during the crisis the Nevada companies entered into over 200 forward contracts, for supply blocks ranging from 25 to 100 MW, at prevailing market prices up to $290/MWh, with ten sellers, including (but not limited to) petitioners Calpine, AEP, and Allegheny. *See* Pet. App. 30a & n.18. These contracts were generally for periods of 1-2 years, precisely the forward contracts that FERC Staff found were most affected by the gross defects in the California spot markets during the crisis period. Pet. App. 58a. The Nevada companies submitted evidence to FERC that the crisis-affected contracts produced a $1 billion increase in the Nevada companies' retail rates over what they would have been in the absence of the crisis. ER646. *See* Pet. App. 64a.[12]

F. The Decisions Below

Starting in late 2001, as the scope of the market manipulation underlying the contracts became apparent, the Western Utilities filed complaints at FERC under FPA § 206 arguing that rampant

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[12] Calpine (CES Br. 19) notes the ALJ's statement (Pet. App. 154a) that the Nevada companies made certain resales of power bought under some of the contracts at issue. FERC itself, as its brief here silently confirms, did not adopt that finding as its own because it was not material to its decision. In any event, if the Nevada companies were able to mitigate damages from the high-cost contracts by selling surplus power under those contracts, such "profits" (if any) could serve only to reduce the overall financial effect of the challenged contracts, not eliminate FERC's obligation to determine whether the rates were just and reasonable.

market failures when these contracts were executed required FERC to reform the contract rates to just and reasonable levels. Respondent Nevada Attorney General's Bureau of Consumer Protection ("Nevada BCP") intervened to seek relief for the electricity consumers it represents.

FERC had already concluded that spot market prices in California could not be deemed just and reasonable. *E.g., San Diego Gas*, 93 FERC ¶ 61,294 at 61,999. Because California is part of a single integrated electricity market in the West, *Avista Corp.*, 96 FERC ¶ 61,058 at 61,179 (2001), *order clarified, Avista Corp.*, , 96 FERC ¶ 61,265 (2001), problems in California "resulted in a dysfunctional marketplace both in California and the remainder of the West." *San Diego Gas & Elec. Co v. Sellers of Energy & Ancillary Services,* 95 FERC ¶ 61,418 at 62,556 (2001). FERC had also recognized that, because "maintaining an accurately priced spot market is the single most important element for disciplining longer term transactions," *AEP Power Mktg., Inc.*, 97 FERC ¶ 61,219 at 61,972 (2001), "[t]hese higher spot market prices in turn affect[ed] the prices in forward markets," *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Services,* 93 FERC ¶ 61,121 at 61,367 (2000). Nonetheless, FERC ordered a hearing, requiring the Western Utilities to demonstrate that the California crisis affected the contracts at issue here, and that the challenged contracts arose from "*extraordinary* circumstances." JA1080a, JA1099a.

After a hearing, the Administrative Law Judge recommended rejection of the complaints. The ALJ concluded that prices in the forward markets were

not influenced by spot market dysfunction, Pet. App. 121a-122a. That conclusion was never adopted by FERC and is now so thoroughly discredited—by, for example, the subsequent findings of the Staff Report[13]—that it has been abandoned by the petitioners and by the ALJ herself. FERC BR. 9; ISDA Br. 19; *see Enron Power Mktg., Inc.*, 119 FERC ¶ 63,013 at ¶ 110 (2007) (ALJ Opinion). The ALJ also concluded that she was bound to review the challenges under a "practically insurmountable" standard attributed to *Mobile* and *Sierra*. Pet. App. 209a.

In a 2-1 decision (with two FERC seats vacant), FERC upheld the ALJ's ruling without reaching the primary issue it set for hearing. JA1222a-JA1323a, JA1554a-JA1614a. FERC insisted that "a finding that the unjust and unreasonable spot market prices caused forward bilateral prices to be unjust and unreasonable would be relevant to contract modification only where there is a 'just and reasonable' standard of review." JA1275a-JA1276a. Instead, FERC applied a separate "public interest" standard, stating that "to justify contract modification it is not enough to show that forward prices became unjust and unreasonable due to the impact of spot market dysfunctions; it must be shown that the rates, terms, and conditions are contrary to the public interest." JA1276a. FERC then held that the "public interest" test was not met, dismissing the extreme rate increases experienced by the Western Utilities as insignificant, JA1276a-JA1280a, and asserting that the contracts were the

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[13] The Staff Report was based, in part, on data not available to the witnesses upon whom the ALJ relied. JA192sa.

result of "voluntary" choices, because, for example, the Nevada companies could have entered into longer-term contracts and Snohomish could have entered into shorter-term contracts, JA1284a-JA1285a.[14]

Commissioner Massey dissented. Noting that the challenged contract prices were "multiples of traditional prices, shockingly high prices, completely unprecedented by historic standards," he concluded that the prices were "unlawful by any reasonable measure" and that FERC's "primary calling under the [FPA] is to ensure that prices are just and reasonable 24 hours a day, seven days a week." JA1301a-JA1302a. Commissioner Massey found "no persuasive public interest rationale for protecting and sanctifying contracts" that were tainted by the "wildly dysfunctional" market, and concluded that the high prices in these contracts were influenced by "the exercise of market power and widespread market manipulation." JA1317a-JA1318a.

The Western Utilities and Nevada BCP sought rehearing, and Morgan Stanley, Allegheny, and others themselves sought a limited rehearing to tell FERC, with delicate understatement, that its decision "contains language that could be construed as suggesting incorrectly that the *Mobile-Sierra*

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[14] Elsewhere, Commissioner Massey described the Commission's Snohomish-too-long/Nevada-Companies-too-short reasoning as "breath[ing] life into the old saying 'damned if you do and damned if you don't.'" *Puget Sound Energy, Inc. v. All Jurisdictional Sellers*, 103 FERC ¶ 61,348 (2003) (Massey, Comm'r, dissenting), *reh'g denied*, 105 FERC ¶ 61,183 (2003), *remanded, Port of Seattle v. FERC*, 499 F.3d 1016 (9th Cir. 2007).

doctrine sanctions unjust and unreasonable rates." ER356B. FERC declined the sellers' invitation to correct its error, and instead reiterated its premise that the public interest standard, which it viewed as mandated by this Court, is entirely separate from the just and reasonable standard. JA1567a.

The Ninth Circuit remanded. Pet. App. 1a-67a. The court did not question FERC's power to authorize sellers to make contracts with limited after-the-fact filing, but found three key flaws in FERC's decisions. First, it concluded that FERC's decisions were undermined by FERC's apparent belief in a Supreme Court-mandated public interest standard entirely different from the just and reasonable standard. *Id.* at 35a-36a. Second, FERC's construction of *Mobile* and *Sierra*, combined with deficiencies in its rate monitoring, had eliminated what FERC has described as "the requisite initial review" (FERC Opp. 13) of contract rates to determine whether they were just and reasonable. Pet. App. 41a. Third, while relying critically on the market as a guarantor of proper rates, FERC blinded itself to key facts about the ability of the market at the time the contracts were executed to produce even presumptively just and reasonable rates; in particular, the court concluded that such a presumption makes no sense unless FERC first determines that the contracts were signed free of "market manipulation, the leverage of market power" or other factors undermining the presumption that the rates were just and reasonable. *Id.* at 57a. The court acknowledged that contract stability is one important consideration, as *Mobile* recognized, but concluded that it does "not justify abnegation of FERC's statutory responsibility to

protect the public from unjustifiably high rates in wholesale contracts." *Id.* at 64a.

FERC opposed review of the decision. It explained, in particular, that the regulatory setting is "far different from that which existed in 2000-2001," cataloguing numerous changes to its own regulatory regime—some required by Congress—and the correction of the flaws in California's deregulatory scheme, all designed to prevent recurrence of the sort of manipulation and gaming that occurred in 2000-2001. FERC Opp. 14-16. FERC also disputed petitioners' claims of dire consequences should the court of appeals decision stand. *Id.* at 12. This Court granted review.

SUMMARY OF ARGUMENT

The Federal Power Act was enacted to protect consumers from excessive rates and it principally does so by requiring that "all rates ... shall be just and reasonable." 16 U.S.C. § 824d(a). Congress was so intent on making that point that it reiterated that unjust and reasonable rates are "unlawful" and provided for FERC to correct rates that are not just and reasonable. 16 U.S.C. §§ 824d(a), 824e(a). Congress also adopted a structural mechanism—effective oversight of rates through filing—deemed necessary (though not sufficient) for assuring just and reasonable rates. 16 U.S.C. § 824d(c), (d).

In its orders in this case, FERC rejected challenges to grossly inflated contract rates. It did so on grounds that misread these statutory constraints and this Court's decisions applying them and that cannot be sustained as reasoned applications of the

statutory standards. The court of appeals correctly remanded for reconsideration.

Most broadly, FERC misread this Court's *Mobile* and *Sierra* decisions as mandating a "public interest" standard separate from and radically more demanding than the statutory "just and reasonable" standard, compelling adherence to contract rates that are not just and reasonable. FERC declared *irrelevant* whether the rates here are just and reasonable, JA1275a, and stuck to that premise when even certain petitioners noted that FERC's reasoning flouted the plain statutory command. JA1567a. Now, government counsel tries to rewrite FERC's rulings, suggesting that they contain a reasoned exercise of discretion *under* the statutory "just and reasonable" to apply a practically insurmountable standard when rates are established by contract. But FERC did no such thing, instead reading *Mobile* and *Sierra* as themselves precluding "just and reasonable" review. This Court may not affirm FERC's decisions under the post hoc rationalization offered by counsel.

The premise of FERC's rulings is plainly wrong. Neither *Mobile* nor *Sierra* immunizes *any* contract rates from the requirement that they be just and reasonable, let alone the contracts here. *Mobile* merely precluded contract changes by a seller's unilateral filing with FERC (not an issue here), and *Sierra* narrowly rejected the claim that rates challenged as too *low* could violate the FPA, which protects consumers from *excessive* rates, simply because the seller made too little profit. The Court's "public interest" language is merely a shorthand reference to the consumer interests protected by the

statutory "just and reasonable" standard. FERC misread these decisions and, as a result, never undertook the required statutory inquiry into excessiveness of rates.

FERC's rejection of the high-rate challenges here could not be sustained even if it were treated as an attempted application, rather than repudiation, of the statutory standards. First, although a *presumption* of justness and reasonableness may be justified for some contract rates, FERC improperly treated respect for market transactions as an end in itself, rather than as the means to the statutory end of just and reasonable rates, and thus disregarded essential prerequisites for a presumption that these means in fact serve the end. Effective competition is an essential prerequisite, but as Professor Kahn noted in May 2001, the western energy market was "not characterized by effective competition" at that time. ER897. FERC, which blinded itself to obvious market-corrupting conditions, has not justified, and cannot justify, a presumption that contract rates are just and reasonable when effective competition is lacking. FERC must explore the market conditions on remand before adopting any presumption that the contracts formed in 2000-2001 were just and reasonable.

Second, FERC's indulgence of such a presumption was also inconsistent with a premise built into the statute. Congress, through its filing requirement, deemed a timely opportunity to review *rates* as essential (though not sufficient) for producing just and reasonable rates, and FERC has conceded that "an opportunity for initial review of whether a rate is just and reasonable is necessary." Pet. App. 39a.

FERC has never provided that opportunity for the contracts at issue. The requirement is not met by FERC's authorization of *sellers* to make contracts in the market, with after-the-fact filing but no effective monitoring and opportunity for timely correction of rates produced in dysfunctional markets. Revocation of sellers' authority fails to provide relief to consumers who bore the brunt of unjust and unreasonable rates. And effective monitoring was sorely lacking in 2000-2001, as the subsequent statutory and regulatory changes confirm.

More generally, the core premise of FERC's rulings and petitioners' arguments here—that contract rates must be effectively immune from agency correction—is unsupported by and inconsistent with this Court's decisions. Support cannot be found in this Court's "unequivocal public necessity" language in *Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968), in a discussion (as in *Mobile* and *Sierra*) of sellers' complaints about rates being *too low*. *Id.* at 820-22. Indeed, *Permian Basin* specifically upheld "abrogation of contract prices *above*" the rates the Commission determined were just and reasonable without applying a practically insurmountable standard. *Id.* at 818 (emphasis added). And in many other cases, this Court has reaffirmed the Commission's authority to override contract rates that are too high, and this Court's decision in *FPC v. Texaco Inc.*, 417 U.S. 380, 384 (1974), squarely prohibits the Commission from relying exclusively on market forces to ensure that rates are not too high.

Petitioners and their amici rely heavily on the policy argument that contract rates must be immune

from review for markets to function. This is a policy judgment for Congress, which has concluded otherwise since 1935, requiring correction of excessive rates even when embodied in contracts. In any event, there is every reason to conclude that confidence in energy markets would be bolstered if participants knew that FERC would review contract rates distorted by severe manipulation and gaming of the sort that created the western energy crisis in 2000-2001—just as an overall commitment to a market regime led economists including Alfred Kahn to urge direct intervention in such unusual and extreme circumstances.

ARGUMENT

I. FERC'S RULINGS REST ON ITS MISCONSTRUCTION OF THE STATUTE AND THIS COURT'S DECISIONS.

The statute requires FERC to ensure that all rates are just and reasonable. FERC failed to do so because it misread *Mobile* and *Sierra* as establishing a practically insurmountable standard governing review of contracts. And any presumption that certain contracts are just and reasonable cannot reasonably be triggered (1) when there is no effective competition and (2) when FERC has not effectively monitored markets and afforded a timely opportunity to correct contracts that are not just and reasonable.

A. FERC Erred by Refusing to Apply the Just and Reasonable Standard.

1. FERC expressly declined to apply the statutory standard, and the agency may not be affirmed based on the post-hoc rationalizations of counsel.

The FPA unambiguously requires *all* rates and terms to be just and reasonable. Section 205(a) declares: "*All* rates and charges made, demanded, or received by a public utility" related to wholesale electric service "*shall* be just and reasonable." 16 U.S.C. § 824d(a) (emphasis added). Section 205(a) then adds: "any such rate or charge that is not just and reasonable is hereby declared to be *unlawful.*" *Id.* (emphasis added). And, consistent with this repeated declaration, the provision directly at issue here, FPA § 206 incorporates a mandatory just-and-reasonable requirement: "Whenever" FERC "shall find that any rate [or] charge," or any "contract affect[ing] such rate [or] charge" is "unjust, unreasonable, unduly discriminatory or preferential, the Commission *shall* determine the just and reasonable rate, charge ... or contract to be thereafter observed" and "*shall* fix the same by order." 16 U.S.C. § 824e(a) (emphasis added).

The FPA is thus cast in universal and mandatory language: *all* rates, charges, and contracts, without exception, must be just and reasonable, and FERC has a mandatory duty to reform rates, charges, and contracts that are not just and reasonable. *See Nat'l Ass'n of Home Builders v. Defenders of Wildlife,* 127 S.Ct. 2518, 2531-32 (2007). As FERC's Chairman recently concluded, "The legal duty of [FERC] to prevent unjust and unreasonable rates ... *is absolute*;

[FERC] does not have the discretion to ignore them." Hon. Joseph T. Kelliher, *Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission*, 26 Energy L.J. 1, 3-4 (2005) (emphasis added). Hence, FERC "cannot honor those contract prices ... found to be unjust and unreasonable." *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Services*, 114 FERC ¶ 61,070 at 94 (2006). Not surprisingly, FERC (Br. 21) and Morgan Stanley (Br. 7 n.4) concede "there is but one statutory standard addressing the lawfulness of wholesale electricity rates" and "[t]hat standard requires *all* rates to be 'just and reasonable.'"

Yet, in this case, FERC refused to apply the just and reasonable standard to respondents' complaints invoking FPA § 206. *See, e.g.*, JA1275a. Instead, FERC applied a different standard, the "public interest" standard, which it improperly construed to impose a much higher hurdle than the just and reasonable standard. JA1275a-JA1280a. Because FERC's interpretation "goes beyond the meaning that the statute can bear," it must be rejected as a matter of law. *MCI Telecomm. Corp. v. AT&T*, 512 U.S. 218, 229 (1994).

FERC seeks to uphold FERC's decisions on the ground that FERC actually did apply the just and reasonable standard. Br. 21. This argument must be rejected because it rests entirely on a rewriting of FERC's orders, in which FERC stated repeatedly it was acting under what it believed to be legal compulsion imposed by this Court's decisions to apply a "public interest" standard different from and distinctively more demanding than "just and reasonable" review. JA1225a, JA1229a, JA1243a-

JA1245a, JA1275-JA1276a; JA1563a-JA1564a, JA1567a, JA1572a-JA1574a; *see also* JA1485a, JA1493a, JA1502a-1503a, JA1507a, JA1518a. FERC did not acknowledge discretion and then engage in a reasoned analysis of how to exercise it. It did not invoke any recognizable "just and reasonable" test or any notion of cost-related rates at the core of "just and reasonable," whether achieved through direct inquiry or reliance on market mechanisms. Rather, FERC invoked "[t]he 'public interest' standard of review" it attributed to *Mobile* and *Sierra* as establishing "the legal parameters within which the Commission must address requests for contract reformation," JA1225a, and applied the "*Sierra* Three-Prong Test," JA1276a-JA1280a, followed by a cursory review of the "Evidence on Totality of Circumstances,"JA1280a-JA1284a. And on rehearing FERC specifically refused sellers' invitation to "clarify" that it really was concluding that the contracts rates satisfied the statutory just and reasonable standard. JA1567a.

An agency's determination cannot be upheld based on counsel's *post-hoc* rewriting of the agency decision to transform it into a reasoned exercise of a broad discretion the agency did not recognize. *See Texaco*, 417 U.S. at 397; *see also Massachusetts v. EPA*, 127 S. Ct. 1438, 1462 (2007); *NLRB v. Kentucky River Community Care*, 532 U.S. 706, 714 n.1 (2001); *NLRB v. Yeshiva Univ.*, 444 U.S. 672, 685 n.22 (1980). Accordingly, whatever else this Court decides, once it concludes that the statute as construed in *Mobile* and *Sierra* does *not* preclude just-and-reasonable review, it must remand the case

to FERC with instructions to apply the statutory standard.[15]

2. *Mobile* and *Sierra* create no exception to the just and reasonable standard.

This Court's decisions in *Mobile* and *Sierra* did not rewrite the statute to require FERC to apply a different and higher standard than the "just and reasonable" standard. On the contrary, the Court recognized "the basic power of the Commission" to "set aside and modify any rate or contract which it determines ... to be 'unjust, unreasonable, unduly discriminatory, or preferential,'" a power which applies to "*all* the rates" of a regulated company. *Mobile*, 350 U.S. at 341 (quoting NGA § 5(a)) (emphasis in original). And it stressed that, while rates may be established initially by contract, "*all* rates are subject to being modified by the Commission upon a finding that they are unlawful." 350 U.S. at 341 (emphasis added). Two years later, in *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Div.*, 358 U.S. 103 (1958)—written by Justice Harlan, author of *Mobile* and *Sierra*—the Court

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[15] FERC states (Br. 29-30) that Congress in the Energy Policy Act of 2005 enacted certain provisions premised on FERC's ability to authorize sellers to make contracts in advance of filing. That is not at issue here. Even FERC does not assert that Congress ratified a "public interest" test different from the statutory just-and-reasonable standard, or FERC's invocation of such a test, or FERC's lax monitoring of contracts. Indeed, the 2005 Act confirms that FERC's lax monitoring was *inadequate*. Moreover, whereas the House passed a bill that would have required FERC to apply a "public interest" standard to contract rates, *see* Energy Policy Act of 2005, H.R. 6, 109th Cong. § 1286 (as passed by House, April 21, 2005), that provision did not survive in the enacted law.

confirmed that filed contracts are subject to the Commission's "paramount regulatory authority under [NGA] § 5(a)," 358 U.S. at 110, the statutory twin of FPA § 206(a). A decade later, the Court in *Permian Basin Area Rate Cases*, again speaking through Justice Harlan, re-emphasized that NGA § 5 "provides *without qualification or exception* that the Commission may determine whether 'any rule, regulation, practice, or contract affecting ... [any] rate ... is unjust, unreasonable, unduly discriminatory, or preferential,'" and that contracts are subject to the Commission's "*plenary authority* to limit or to proscribe contractual arrangements that contravene the relevant public interests." 390 U.S. at 784 (emphasis added) (alterations in original).

The *Mobile* and *Sierra* opinions plainly do not remove contract rates from the statutory "just and reasonable" standard. Nor do their holdings. *Mobile* held only that the rate-filing requirement of NGA § 4 did not empower a seller, simply by filing a new tariff, to raise a contract rate unilaterally. And *Sierra* held only that the Commission could not find a contract rate unreasonably *low*, and thus impose on consumers a rate higher than the agreed contract rate, merely "because it yields less than a fair return" on the seller's invested capital. *Sierra*, 350 U.S. at 355. Because *raising* rates generally benefits only the "private interests of the [selling] utilities," this Court concluded that the Commission's action was contrary to "the purpose of the power given the Commission by [FPA] § 206(a)," which is "the protection of the public interest." *Id.*[16]

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[16] In *Sierra*, this Court recognized that the 2.6% rate of return PG&E obtained under the contract was below PG&E's

While FERC has construed the "public interest" language to erect a nearly insurmountable obstacle to reforming unjust and unreasonable contracts, the Court plainly meant something very different. The Court in *Sierra* used "public interest" as a shorthand for the consumer interests that contrast with the "private interests" of sellers, and it is the consumer interest in "lowest possible reasonable rate consistent with the maintenance of adequate service," *Atlantic Ref.*, 360 U.S. at 388, that the statutory "just and reasonable" requirement protects.

FERC thus erred in its keystone conclusion that this Court, in *Mobile* and *Sierra*, displaced the statutory standard with a "public interest" standard that precludes reform of contracts even if they are unjust and unreasonable.

B. If FERC's Orders Are Viewed as Purporting to Apply the Statutory Standard, They Are Unreasonable.

Even if FERC's orders were read as invoking *Mobile* and *Sierra* as general support for one potential (though not required) application of the

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"normal[]" reasonable rate of return, 350 U.S. at 353, and it quoted a cursory Commission conclusion that the 2.6% rate of return was unreasonably low. *Id.* at 354. This Court specifically disapproved the Commission's standard for "reasonable." *Id.* The low end of the range of reasonableness, the Court held, was not the normal rate of return—which the Commission might adopt if itself setting an individual rate—but that which would translate into harms to the *public*, namely, consumers. *Id.* at 355. The low end of reasonableness is what would constitute confiscation, this Court has said, and confiscation is generally measured by the *overall* rate structure, not individual contracts. *Verizon Commc'ns, Inc. v. FCC*, 535 U.S. 467, 481, 526-27 (2002); *Permian Basin*, 390 U.S. at 769-70, 804-05 n.82.

statutory standard, the orders could not be upheld. The most that *Mobile* and *Sierra* could lend support to, consistent with their confirmation of the general role of contracts under the statutes, is a presumption that certain contract rates are just and reasonable. But the prerequisites for any such presumption to comport with the statute are critical, and the orders under review are inconsistent with those prerequisites.

The FERC orders rest on a broad proposition: that contract rates may be deemed just and reasonable merely because the contracts were executed by sophisticated entities, no matter the market circumstance, if the sellers had once been found to have lacked or mitigated the ability to exercise market power. FERC Br. 22-24; MSCG Br. 30-31; CES Br. 34, 39-40. That proposition is an impermissible application of the FPA.

1. A presumption that contract rates are just and reasonable cannot reasonably apply when effective competition is lacking.

Where effective competition exists, it can be reasonable to assume that a negotiated contract rate is just and reasonable (if other preconditions are also met, *see* point 2, *infra*). But it is not reasonable to apply such a presumption where effective competition is lacking. That was so in the western energy markets in 2000-2001, where, among other things, the market was severely manipulated and state law limited natural market corrective mechanisms.

The lower courts and FERC itself have consistently recognized that FERC may rely on market forces to produce just and reasonable rates *only if* FERC ensures the presence of proper "competitive markets." *Consumers Energy*, 367 F.3d at 922-23; *see Lockyer*, 383 F.3d at 1014-15; *Elizabethtown Gas*, 10 F.3d at 871; *LEPA*, 141 F.3d at 369-71; *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1501-09 (D.C. Cir. 1984); *San Diego Gas & Elec.*, 93 FERC ¶ 61,294 at 62,011. This conclusion follows well-established principles of economics, which recognize that a market will not function to produce reasonable prices if it is distorted by, for example, market power or other impediments to buyers' choice or the dissemination of inaccurate market information.[17] In short, it does not make sense to presume that contract rates are just and reasonable if they were negotiated in a market lacking competition sufficient to drive rates into the zone of reasonableness.

The facts here illustrate why it makes no sense to presume that contract rates are just and reasonable when effective competition is lacking. Forward

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[17] *E.g.*, Robert Cooter & Thomas Ulen, *Law and Economics* 235-40 (1988) (rules related to respect for contracts make "four assumptions about the contractual environment—no adverse third-party effects, full information, many available contractual partners, and zero transaction costs"); Breyer, *Regulation and Its Reform* at 26 ("For a competitive market to function well, buyers must have sufficient information to evaluate competing products."); Richard A. Posner, *Economic Analysis of Law* 109-16 (4th ed. 1992) (market failure may arise from incomplete information or market power); *California Dental Ass'n v. FTC*, 526 U.S. 756, 773 n.9 (1999) (false information in a market can produce inefficient results).

markets in the western United States collapsed during the 2000-2001 energy crisis, with the few available suppliers exercising substantial market power. ER894-895; Record No. 1602 at 64-65. As the FERC Staff Report showed, Morgan Stanley was one of the few suppliers operating in long-term markets, resulting in "a highly concentrated market vulnerable to the exercise of market power" in which "workable competition" was unlikely. ER359-ER361. More generally, there were no reliable forward prices upon which to base projections of future price trends, so market participants had to rely on spot-market transactions—which were riddled with fraud and manipulation. *See* ER894-ER895; Record No. 1602 at 64-65; Record No. 1615 at 24-27. The forward markets were devastated by these abuses. Dr. Timothy Mount, an economist at Cornell University, offered an econometric model in testimony demonstrating that the "shock" of rapid increases in spot-market prices raised forward-market prices by 80-90% during the crisis period. ER1034-ER1041.

The collapse of the forward markets produced severe consequences for the Western Utilities. Thus, Snohomish lacked a meaningful choice of suppliers, as only three bidders responded to its need for 75-100 MW, each unwilling to offer more than 25 MW. Because Snohomish was legally obligated to purchase energy to ensure that "hospital lights stay on and businesses stay open," ER88-ER89, it had no options to resist sellers' exercise of market power.

Recorded conversations of Morgan Stanley principals demonstrate their own recognition of

Morgan Stanley's market power.[18] Morgan Stanley knew Snohomish had "nobody to go to," ER529, that the rapid escalation of prices was putting "pressure" on Snohomish to execute a contract quickly,[19] and that Snohomish could not get what it wanted because "[e]verybody" else who responded to the RFP was also "repricing and repricing."[20] The tapes also demonstrate that Morgan Stanley knew that Snohomish was receiving fundamentally a "bad deal"[21] that included "padding" of Morgan Stanley's price,[22] causing Morgan Stanley's traders to celebrate.[23]

Morgan Stanley ultimately told Snohomish that it simply had to accept the bad deal it was offering.[24] The record shows that a functional market would have produced long-term prices approaching $35/MWh at the time the contract was executed. The

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[18] Most energy contracts are negotiated quickly over the telephone and do not result in a written agreement. The negotiations are regularly recorded so there is a record to consult in any subsequent dispute.

[19] ER525; ER833.

[20] ER523-ER524; ER1087A:1-8.

[21] Record No. 1198, Vol. 3 at 88 (describing "bad deal").

[22] Record No. 1198, Vol. 4 at 26:20-22.

[23] ER834 ("[t]here's a lot of money in this," and "now you understand why everybody is all over this").

[24] *See* ER523:9-10; ER524:20-21 (Morgan Stanley's negotiator tells Snohomish it must execute the contract "quickly" "to hold off the elephants"; Snohomish's negotiator pleads for "15 minutes to read [the contract]."). Morgan Stanley thought this pressure would force Snohomish to "cave tonight and just sign what we have." ER526:11-13.

signed contract rate of $105/MWh is therefore approximately triple what the price for such long-term contracts would have been in a functionally competitive market. Record No. 1595 at 13-14, 16-34; ER1058-63; ER1019-21.

Similarly, with respect to the Nevada companies, FERC's own Staff Report shows that the influence of out-of-control spot-market prices during the crisis was "greatest for forward contracts with the shortest time to delivery (1-2 years)," JA190sa, precisely the term of the Nevada companies' contracts at issue. *See* Pet. App. 58a. Accordingly, the problem is not, as FERC claims (Br. 44) that there is "no evidence" that the forward markets were not effectively competitive, the problem is that FERC ignored the evidence in this case. Yet in a different proceeding FERC concluded that Enron's abuses had "undermine[d] the functioning of the wholesale power market and our reliance on that market to ensure that rates are just and reasonable." *Enron Power Mktg., Inc.*, 106 FERC ¶ 61,024 at ¶ 9.

FERC therefore could not reasonably presume the contracts at issue to be just and reasonable without considering the market's functioning in 2000-2001. FERC's claim (Br. 46) that there was no evidence that the contract rates were unjust and unreasonable from the start is simply wrong. Similarly, the claim (FERC Br. 45; MSCG Br. 34-35) that buyers and sellers had "equal access to information" concerning the market meltdown would not be sufficient even if true, but also is contrary to the record evidence—which demonstrates, *e.g.*, that Morgan Stanley's traders were aware of market manipulation and

other forms of abuse of which Snohomish was ignorant.[25]

Nor can the market-specific inquiry be dismissed as unnecessary (FERC Br. 22-24; MSCG Br. 30-31; CES Br. 34, 39-40) based on this Court's observation in *Verizon* that Congress expected that buyers and sellers in wholesale markets "often" were "sophisticated [parties] enjoying presumptively equal bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the two of them." 535 U.S. at 479. That observation does not purport to exhaust the reasons markets can fail. And in any event, an assumption about what is "often" or even generally true provides no excuse for refusing to examine the evidence that the assumption is false in this specific case.

This Court should hold that it is not reasonable to presume that contract rates are just and reasonable when effective competition is lacking. It should instruct FERC, on remand, to reexamine the evidence involving the soundness of the forward energy markets during the western energy crisis. If FERC concludes that those markets were not effectively competitive, it should not invoke any presumption that contract rates are just and reasonable, but instead should establish just and reasonable rates using an appropriate measure of

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[25] Record No. 780 at 1971:14-1974:5 (Morgan Stanley trading manager knew that "artificial goosing up of trading volume" was "blatant" in the industry); Record No. 1648 at 55-66 (Morgan Stanley's principal contract negotiator engaged in conversations related to the intentional creation of transmission congestion).

what would have been produced in a competitive market or other ratemaking principles.

2. A presumption that contract rates are just and reasonable cannot reasonably apply where there has never been an opportunity to apply the statutory standard to the contract.

As this Court has stated, "the clear purpose of the congressional scheme" was to ensure that FERC had "an opportunity *in every case* to judge the reasonableness of the rate." *Arkla*, 453 U.S. at 582 (emphasis added) (citation omitted). That requirement is implicit in the rate- and contract-filing requirement, 16 U.S.C. § 824d(c), (d), as well as the just and reasonable requirement. Accordingly, FERC itself has long recognized that, if it applied a "practically insurmountable" standard of review to contract rates without ever previously having had the opportunity to consider the justness and reasonableness of the contract, its "ability to meet [FERC's] overarching public interest responsibilities would be virtually precluded."[26] *See* Pet. App. 39a.

FERC must respect "Congress's chosen means of preventing unreasonableness," here the opportunity-for-initial-review requirement of the FPA. *MCI*, 512 U.S. at 230. Indeed, in *MCI* the Court rejected an agency attempt to relieve carriers of a statutory

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[26] Order No. 888-A, FERC Stats. & Regs. Preambles ¶ 31,048 (1997), *order on reh'g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), *order on reh'g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), *aff'd in relevant part, Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff'd, New York v. FERC*, 535 U.S. 1 (2002).

filing requirement that, the Court explained, was central to the statute. *Id.* at 229-32. Although FERC notes that the FPA gives it discretion concerning details related to filing (Br. 28), FERC does not argue, and could not reasonably contend, that it has discretion to devise a system providing no substitute for the basic function of the congressional mechanism: a timely opportunity for monitoring and correcting rates that are not just and reasonable. If the opportunity for challenge under a just-and-reasonable standard is not available *before* the rate takes effect, it must be provided in a timely manner, whether through individual or en-masse FERC review. Without the opportunity for "the requisite initial review" (FERC Opp. 13), a congressionally prescribed premise for ensuring just and reasonable contract rates is lacking.

The regulatory system provided the required opportunity in *Mobile* and *Sierra,*[27] but the regime in place at FERC in 2000-2001 did not. In 2000-2001, FERC's post-contract quarterly filing system was in disarray, as confirmed by the extensive changes subsequently put in place by Congress and FERC itself. And, when confronted with evidence of gross market failure, FERC asserted that, when it originally granted market-based rate authority to petitioners, it "predetermined" all their contracts to be just and reasonable, *see* JA1567a, although FERC now acknowledges that the circumstances at the

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[27] In *Mobile,* the contract went into effect "with the approval of the Commission," 350 U.S. at 336, and in *Sierra,* the relevant contract was "duly filed," 350 U.S. at 353. Hence, the Commission had the *opportunity* to review the contracts in the first instance under the statutory just and reasonable standard.

time a seller is granted market-based rate authority can change unpredictably, Br. 34. Because FERC's "predetermination" rationale leaves no room for buyers to challenge the sellers' subsequently contracted-for rates as unjust and unreasonable based on market failures, FERC's orders improperly cut a hole in the comprehensive protective regime Congress specified.[28]

Contrary to its position in 2000-2001 that buyers must pursue relief through Section 206 complaints and not through challenges to a seller's market-based rate authority, *see San Diego Gas & Elec. Co.*, 96 F.E.R.C. ¶ 61,120 at 61,515 n.59 (2001), FERC (Br. 35) and sellers (MSCG Br. 43) point to the possibility of revoking sellers' market-based rate authority, *i.e.*, their authority to make contracts with only post-contract filing. FERC carefully does not assert that this is an adequate remedy, and it is not. The remedy is a mismatch for *contract* problems. If the problem, as in 2000-2001, is with some or all contracts in the market for a particular time, focusing on a particular seller may be over- and under-inclusive. Manipulation and gaming problems may or may not be "market power" problems; severe market problems may be transitory; and in any event, FERC has not made revocation available based on a seller's profiting from rates artificially

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[28] Sellers have successfully asserted that the filed rate doctrine bars lawsuits alleging violations of state and federal antitrust and unfair competition laws, leaving FERC as the only remaining cop on the beat. *E.g., Public Util. Dist. No. 1 of Snohomish County v. Dynegy*, 384 F.3d 756 (9th Cir. 2004). Such results make it all the more harmful when FERC disclaims its statutory duty to review rates for justness and reasonableness.

inflated by the misconduct of others, leaving the seller's customers without a remedy.

Moreover, it would have been wholly impractical—and therefore no remedy at all—for the Western Utilities to challenge the market-based rate authority of *every* seller from which they might *possibly* purchase power before entering into any contracts. Even if such a "remedy" were not impractical, FERC's suggested avenue of relief would be *more* disruptive to the markets than challenges to individual contracts because a challenge to a seller's market-based rate authority potentially would invalidate *all* contracts made by the seller after the refund effective date, in contrast to targeted litigation over specific contracts.

FERC's treatment of Enron demonstrates the inadequacy of this remedy, as the court of appeals explained. Pet. App. 54a. FERC granted Enron market-based rate authority in 1993, *Enron Power Mktg., Inc.*, 65 FERC ¶ 61,305 (1993), years before the crisis. When it finally revoked the authority in June 2003, two years after the crisis and eighteen months after Enron went bankrupt, FERC did so only *prospectively*—despite recognizing that Enron's abuses rendered rates "unjust and unreasonable from the summer of 2000," and that Enron's abuses "undermin[ed] the functioning of the wholesale power market and our reliance on that market to ensure that rates are just and reasonable." *Enron Power Mktg., Inc.*, 103 FERC ¶ 61,343 at ¶¶ 7, 56 (2003). And when the Western Utilities argued to FERC that its action did nothing to undo the effects even of Enron's specific contracts, let alone of all the contracts *affected* by Enron's practices, FERC

refused to allow the Western Utilities to participate in the proceeding. *Fact-Finding Investigation of Potential Market Manipulation of Electric and Natural Gas Prices,* 105 FERC ¶ 61,063 at ¶ 5 (2003). As a result, the Nevada companies and Snohomish were forced to settle their disputes with Enron at prices reflecting Enron's inflated rates. *See San Diego Gas & Elec. Co. v. Sellers of Energy and Ancillary Services,* 114 FERC ¶ 61,067 (2006); *Nevada Power Co. and Sierra Pacific Power Co. v. Enron Power Mktg. Co., Inc.*, 108 FERC ¶ 61,074 (2004). FERC thus imposed the "death penalty" on an entity that was already dead and its action provided no relief to consumers burdened by Enron's market-manipulation schemes.

In short, contract rates should not be presumed to be just and reasonable merely because the seller had been determined in the past to lack market power and its market-based rate authority might be revoked. Instead, before the presumption is triggered, FERC must be in a position to monitor rates and review them applying the just and reasonable standard where evidence is presented that undermines the assumption that the rates were established in a functional marketplace. The contracts at issue have never been subject to that required review.

3. FERC's "totality of the circumstances" analysis did not ensure that the rates at issue are just and reasonable.

Contrary to FERC's contention (Br. 42-47), FERC's brief discussion of the "totality of the circumstances" (JA1280a-JA1284a) does not satisfy its statutory obligations. Dispositively, FERC

conducted that review only under a "public interest" standard specifically distinguished from "just and reasonable" review. FERC did not say, and could not have said, that this discussion would have supported rejection of the Western Utilities' complaints under the "just and reasonable" standard. Any relevance of this analysis must be considered on remand under the proper standard.

Such a remand will afford FERC an opportunity to attend to evidence it disregarded when applying its practically insurmountable standard. FERC described the Western Utilities as having made "voluntary choices," JA1285a, but it did not find that *untainted* prices were available to meet the Western Utilities' needs. FERC's focus on whether petitioners specifically engaged in misconduct, JA1285a, not only ignored evidence cited above that they did, but disregarded the effect of others' manipulations on what these sellers could and did charge. FERC made no finding of how much retail rates increased—by the specific contracts or all tainted contracts—above *what they would have been in a competitive market.* It disregarded the facts that Snohomish is projected to lose approximately $153 million over the life of the Morgan Stanley contract alone and that the retail rate increases suffered by Snohomish's ratepayers because of the crisis-induced increases in wholesale power costs led to the highest rate of customer disconnections in more than 50 years. ER982, ER1001. Nor did FERC analyze the facts relevant to whether, as FERC now asserts as a mere possibility (Br. 45-46), it *actually would be* difficult to unravel the steps between the generation of the electricity at issue and its sale to the Western Utilities; and the unaddressed record evidence shows otherwise.

ER1086. FERC should examine these and other issues on remand without the blinkers that compromised its 2003 analysis.

The Western Utilities do not contend, as FERC suggests (Br. 46), that the contract rates at issue should be revised even if they were just and reasonable when negotiated and became excessive later on account of the normal actions of markets. The Western Utilities contend that the rates were unjust and unreasonable when the contracts were signed on account of manipulation and other problems in the markets. The Western Utilities sought to keep their costs low, but they had to buy at grossly inflated rates in a market lacking effective competition and with no FERC-provided monitoring and opportunity for timely correction.

As Commissioner Massey stated, the "shockingly high" rates, "unlawful by any reasonable measure," resulted from "the exercise of market power and widespread market manipulation." JA1301a-JA1302a, JA1318a. FERC's rejection of the challenges to these rates rests on FERC's misunderstanding of and failure to fulfill its statutory role and should not stand.

C. Sellers Cannot Opt Out of Regulation By Contract.

Neither FERC nor petitioners argue that the general Western States Power Pool Agreement Section 6.1—the only agreement covering the Western Utilities other than Snohomish—effected a waiver of otherwise-applicable rights under FPA § 206. As to Snohomish, however, FERC makes a one-sentence passing suggestion (Br. 45), and

Morgan Stanley a slightly longer argument (Br. 38-40), that a particular provision of its contract effected a waiver of Section 206 standards that would otherwise apply. That argument is incorrect.

The statute requires *all* terms of contracts to be just and reasonable, and if the market was so defective that Snohomish was effectively forced into an unreasonable contract, the same defect infects the particular provision on which Morgan Stanley relies. More generally, FERC has long held that contracts must initially be reviewed under the just and reasonable standard regardless of contractual language, *e.g.*, *ISO New England, Inc.*, 109 FERC 61,147 at 72 (2004), *aff'd Maine Pub. Utils. Comm'n v. FERC*, 454 F.3d 278 (D.C. Cir. 2006), because restricting initial review would render FERC's ability to protect consumers "negligible," "public regulation would consist of little more than rubber-stamping private contracts," *Northeast Utils. Service Co.*, 66 FERC 61,332 at 62,087 (1994), *aff'd Northeast Utils. Service Co. v. FERC*, 55 F.3d 686 (1st Cir. 1995), and "*effective rate regulation would come to an end.*" *Florida Power & Light Co.*, 67 FERC ¶ 61,141 at 61,397 (1994) (emphasis added). That is particularly the case where contractual third parties, like the Snohomish ratepayers who intervened here seeking relief under Section 206, JA1171a-JA1172a, will bear the burdens of the excessive contract. *PJM Interconnection, LLC*, 96 FERC 61,206 at 61,878 (2001); *see also id.* at n.13 (collecting cases). Yet FERC here applied precisely the "practically insurmountable" burden it heretofore condemned to contracts it had never previously reviewed.

Further, the FPA declares unjust and unreasonable rates to be "unlawful," 16 U.S.C. § 824d(a), and long-established principles of contract law barring illegal contracts would prevent enforcement of any agreement to allow unjust and unreasonable rates. Richard A. Lord, 8 Williston on Contracts at §§ 19:41, 19:43 (4th ed. 1998); Restatement (Second) of Contracts § 178. Hence, parties to FERC-jurisdictional contracts can do no more than agree to fix rates *within* the zone of reasonableness. *Arkla*, 453 U.S. at 605 (Stevens, J., dissenting).

Finally, Morgan Stanley misinterprets the relevant contract provision. Section 39B of the Morgan Stanley-Snohomish contract specifies that the "rates for service" will be "fixed," but does not by its plain terms restrict Snohomish's challenges to the extraordinary length or other provisions of the contract at issue in Snohomish's complaint. The word "rate" means "*a charge per unit* of a public-service commodity (as electricity...)," Webster's Third New International Dictionary (Unabridged) at 1884 (1981), a definition followed by this Court, *FPC v. Louisiana Power Co.*, 406 U.S. 621, 637-38 (1972), by FERC, 10 C.F.R. § 903.2(*l*), by industry practice, ER1016, and in legal parlance, Black's Law Dictionary at 1261 (6th ed. 1990). "Rate" is understood to exclude "non-rate" terms, *Columbia Gas Transmission Co.*, 100 FERC ¶ 61,084 at ¶ 101 (2000) (distinguishing between "rate" and "length of contract"); 10 C.F.R. § 903.2(m), and Snohomish's complaint therefore fully complied with Section 39B. Morgan Stanley now asks this Court to rewrite Section 39B to cover "all rates, terms and conditions of the contract." *Cf.* JA1490a-JA1491a (contract

declaring all "rates, terms and conditions" are just and reasonable). The Court should reject that invitation.

II. THE ARGUMENTS THAT CONTRACT RATES SHOULD BE IMMUNE FROM REVIEW ARE BOTH CONTRARY TO THE STATUTE AND BAD POLICY.

FERC, petitioners, and their amici supporters rely heavily on arguments that contract rates should be effectively immune from review. As a legal matter, that argument should be addressed to Congress, which enacted a statute that requires rates to be just and reasonable and directs FERC to correct rates that are not. Moreover, as a policy matter, it would be unwise to immunize from review rates "negotiated" in circumstances as severe as the 2000-2001 western energy crisis. Markets in the process of becoming competitive function better when there is a regulatory backup that corrects problems arising from manipulation and gaming of a system in the process of transition from monopoly to competition.

A. The Interest in Contract Stability Does Not Override the Statute's Requirement that All Contracts Be Just and Reasonable.

Relying on *Permian Basin*, FERC (Br. 21-25) and Morgan Stanley (Br. 30, 46) argue that FERC's refusal to examine whether the contracts at issue were just and reasonable is justified by concerns related to stability of contracts. But as we demonstrated above, the statute unequivocally declares that *all* rates and contracts must be just

and reasonable and declares *unlawful* any that are not. Hence, while stability of contracts is one value that FERC may properly consider under the statute, that value is subject to explicit statutory limits, and FERC, cannot in the name of contract stability, enforce contracts that are unjust and unreasonable. Congress declared such a result "unlawful."

The Court's decision in *Permian Basin* makes clear that FERC can consider consumer interests related to stability of contracts only if it *first* ensures that rates are *within* the zone of reasonableness. 390 U.S. at 797, 822. Accordingly, in *Permian Basin* this Court upheld the Commission's "abrogation of contract prices above the area maximum rates" the Commission there found to be just and reasonable, *id.* at 818, as well as the Commission's prohibition on certain contractual clauses that would cause contract rates to exceed the maximum area rates. *Id.* at 764 n.30, 781-84. The Court approved the Commission's abrogation of contracts pre-dating the area rate proceedings because failure to reform the contracts would have left consumers "without effective protection against steadily rising prices," and therefore would have "contravene[d] the relevant public interests" protected by the statute. *Id.* at 782, 784.

The statement relied upon by FERC and petitioners, in which this Court required a demonstration of "unequivocal public necessity," addressed attempts by regulated sellers to *raise* the maximum area rates in reliance on pre-existing contracts. *See id.* at 820-22. The Court reiterated *Sierra*'s holding that, where a seller seeks to increase a contract price, the Commission cannot "abrogate

existing contractual arrangements unless the contract price is so 'low as to adversely affect the public interest.'" *Id.* at 820. The Court accordingly refused the producers' invitation "to make adjustments in the area rates because of prevailing contract prices," finding that the Commission's rate structure did not "deny producers revenues consonant with just and reasonable rates" and that the adjustment sought by producers would only "increase the cost of natural gas to some groups of consumers, in order simply to offset bargains previously obtained by others." *Id.* at 822. This context makes plain that the Court's admonition requiring "unequivocal *public* necessity" to increase contract rates merely restates *Sierra*'s requirement that FERC may *raise* fixed contract prices only if it can identify a "public" benefit to the consumers protected by the statute, and cannot do so only to benefit the seller's private interests.

In fact, in *every case* this Court has decided presenting the issue, it has rejected the claim that *Mobile* and *Sierra* mandate contract sanctity and limit the Commission's authority to override excessive rates as unjust and unreasonable. A few years after *Mobile* and *Sierra*, the Court concluded that natural gas is permanently committed to the Commission's interstate jurisdiction once an interstate delivery contract commences and held that contract terms seeking to limit the duration of the interstate dedication are ineffective to overcome the statute's requirements. *Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137, 155-56 (1960); *Sun Oil Co. v. FPC*, 364 U.S. 170 (1960); *United Gas Pipeline Co. v. McCombs*, 442 U.S. 529, 537-40 (1979) (summarizing history of these cases). *Accord*

California v. Southland Royalty Co., 436 U.S. 519, 522-30 (1978). To hold otherwise would allow regulated companies "by a contract clause" to "immunize a particular supplier from the reach of federal regulation," a result contrary to the comprehensive regulatory scheme contemplated by Congress. *California v. Lo-Vaca Gathering Co.*, 379 U.S. 366, 370 (1965).

In *FPC v. Texaco, Inc.*, 377 U.S. 33 (1964), this Court examined the Commission's determination that automatic price escalation clauses in gas contracts are "contrary to the public interest" protected by the Act because they threaten "waves of [price] increases which have no defensible basis" and therefore should be barred by regulation. *Id.* at 42 n.12. This Court upheld the Commission's action, concluding that "[n]atural gas companies that seek to enter the field with prearranged escalator clauses and the like have a built-in device for ready manipulation of rates upward," and that FERC's regulation rendering such contract provisions inoperative was consistent with "the aim of the Act to protect the consumer interest." *Id.* at 41-42.

In *Louisiana Power*, this Court upheld the Commission's imposition of tariff amendments designed to protect homes, schools, and hospitals from natural-gas curtailments even though the amendments overrode contracts guaranteeing deliveries to certain industrial customers. This Court rejected the assertion that "permitting the tariff amendments to take effect despite contrary terms in existing contracts is inconsistent with" *Mobile*. Emphasizing that *Mobile* involved "an attempt by a pipeline *unilaterally* to effect a change in its contract

terms by making a filing under § 4" of the NGA, this Court concluded that *Mobile* does not restrict the Commission's authority to act under other provisions of the statute because "contracts remain fully subject to the paramount power of the Commission to modify them when necessary in the public interest." 406 U.S. at 646 (quoting *Mobile,* 350 U.S. at 344). It held that the "public interest" was served by protecting schools, hospitals, and homes "completely dependent on a continued natural gas supply" from unnecessary curtailment of that supply. 406 U.S. at 632.

In *Arkla*, this Court refused enforcement of a contract provision that would entitle the producer to a higher rate, because the producer had not complied with the NGA's filing requirements. Emphasizing that *Mobile* and *Sierra* do "not affect the supremacy of the Act itself," this Court stressed "the clear purpose" of the filing requirements—to grant FERC "an opportunity in every case to judge the reasonableness of the rate"—and held that enforcing a contract not in strict compliance with the statute's filing requirements "would give inordinate importance to the role of contracts between buyers and sellers in the federal scheme" of regulation. 453 U.S. at 582.

In dicta noted by FERC (Br. 22) and Morgan Stanley (Br. 30, 46), the Court in *Arkla* stated that the Commission may alter contracts only in "extraordinary circumstances." 453 U.S. at 582. But no issue of FERC modification was presented, and the case involved a seller's attempt to *raise* its rates. In any event, FERC's rejection of the complaints in the present case does not apply an "extraordinary circumstances" standard even though FERC

originally set this case for hearing using that standard. JA1099a. That hearing documented the most extraordinary circumstances in the history of the industry. Accordingly, even if the *Arkla* formulation were applicable, FERC failed to comply with it.

Finally, in *FPC v. Texaco Inc.*, the Court recognized that FERC's authority to rely on contract rates is necessarily limited by the statutory command that rates be just and reasonable. 417 U.S. at 384. In 1970, the Commission relieved small natural-gas producers from most of the NGA's filing requirements and assured those producers that their contract rates would not be subject to change, reasoning that competition from larger producers would keep the rates charged by smaller producers in check. This Court held "that the Commission lacks the authority to place exclusive reliance on market prices." *Id.* at 400. The Court agreed that "the Commission may have great discretion as to how to insure just and reasonable rates," but held that the Commission must insure that "the rates paid by pipelines, and ultimately borne by the consumer, are just and reasonable." *Id.* at 394, 401. Thus, *Texaco* makes clear that FERC's reliance on market forces is subject to the overriding obligation of regulatory oversight to ensure just and reasonable rates.

B. Reformation of the Contracts at Issue Will Improve Market Functioning, Not Harm It.

As FERC recently stated, "In order to attract the supply and investment in production and infrastructure on which the ... markets rely, the prices sellers obtain for their product must be based

on a *fair and well-functioning market*." *Amaranth Advisors, LLC*, 120 FERC ¶ 61,085 at ¶ 123, *reh'g denied*, 121 FERC ¶ 61,224 (2007) (emphasis added). Record evidence never addressed by FERC demonstrates that reform of contracts tainted by market distortions is, consistent with FERC's recent admonition, necessary to ensure a "fair and well-functioning market." Indeed, the prospect of such intervention helps induce market participants themselves to improve market functioning rather than exploit defects.

As previously noted, in the midst of the crisis ten leading academic economists, including Alfred Kahn, wrote a letter to the President and to Congress warning that FERC's failure to "effectively enforce the provisions of the [FPA] that require it to set just and reasonable wholesale prices for electricity" will have "dire consequences" and will "setback [*sic*], potentially fatally, the diffusion of competitive electricity markets across the country." ER896, ER898. This prediction proved prophetic, as States across the country have, since FERC's regulatory abdication, rolled back or eliminated plans to deregulate their retail electricity markets. Record No. 1615 at 89-90.

The failure to remedy contracts distorted by serious manipulation and other abuses undermines market performance in many ways. Abuses can send false price signals, potentially causing a wasteful and expensive boom-and-bust investment cycle in the industry that disrupts efficient investment and produces unemployment across the economy. Record No. 1413 at 45-47; Record No. 1615 at 88:14-26; Record No. 1559 at 96:4-14; Record No. 1602 at 54-

55. The absence of forceful correction of serious market abuses also can deter buyers from entering the forward markets. Similarly, it can encourage buyers to build their own generation, even if doing so is less efficient than buying on the market. Record No. 1420 at 17, 22; Record No. 1416 at 21; Record No. 1391 at 29.

On the other hand, reform of tainted contracts can improve market performance. It can reduce risk premiums, increase market liquidity, and provide for stable long-term markets. ER1048-ER1049; Record No. 1595 at 42. Experience in overseas electricity markets, the domestic natural gas market, and relevant commodity markets confirms the benefits. Record No. 1595 at 7-8, 35-44; Record No. 1602 at 56-57; Record No. 1615 at 83, 85:8-88:3.

Virtually all of petitioners' arguments to the contrary betray their own weakness by attacking a straw man—asserting that it would be unwise to open all contracts to attack, even where no market failure is involved. MSCG Br. 35 ("mere market shifts"); CES Br. 33 ("simply because it is unprofitable"), 48; Coral Power Br. 20-21; Baumol Br. 20 ("solely on a change in market conditions"); ISDA Br. 12 ("merely because [contracts] do not satisfy a cost-based standard").[29] We do not suggest

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[29] The Baumol brief, as it discloses (2 n.1), was paid for by petitioners in No. 06-1468, the "Dynegy" petition the Court is presumably holding until the present cases are decided. Two of the amici joining that brief, Hogan and Kalt, were paid experts for sellers in the FERC proceeding. *Cf. id.* at 2a (noting role as "an expert"). Other independent academic economists have rejected amici's claim, *id.* at 22-23, that market manipulation and abuse played no role in the Western crisis. Record No. 1602 at 29-41.

otherwise. The Western Utilities have never challenged the presumption of reasonableness for contract rates where the only complaint is a change in ordinary supply-demand dynamics. *See* CES Br. 34-35. The market manipulation and gaming of the new deregulatory system in 2000-2001 went far beyond ordinary supply-demand dynamics. Reforming the contracts tainted as a result would not compromise forward contracts entered into in ordinary market conditions so long as FERC makes clear that the relief it ultimately grants will not affect contracts made in such conditions. Record No. 1602 at 49; Record No. 1595 at 42-43.

Nor is there merit to petitioners' arguments that granting relief here will create undue uncertainty. MSCG Br. 36-37; CES Br. 48-52. On remand, FERC need only make clear the standard it will use to determine when intervention is needed and how it will be administered. Record No. 1595 at 16-35, 41-43; Wolak, *supra* at 34 ("Setting an *ex post* standard for what constitutes a just and reasonable market price" satisfies market need for certainty).[30] FERC has already rejected arguments (MSCG Br. 44) about administrative burdens. *CAlifornians for Renewable Energy, Inc.*, 119 FERC ¶ 61,058 at ¶¶ 27-29 (2007). And in any event, because the 2000-2001 crisis was so unusual, investors view the event as *sui generis*

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[30] Sellers complain (Coral Power Br. 24; *see also* Baumol Br. 21-22) that market "dysfunction" is not sufficiently precise. But it is FERC that first employed the term to describe the multiple breakdowns of the western power markets. *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Services*, 93 FERC ¶ 61,121 at 61,349 (2000). We agree that FERC should provide necessary clarification of the term on remand.

and intervention by FERC will therefore create little, if any, regulatory risk. Record No. 1413 at 47; Record No. 1595 at 35, 42-43; Record No. 1602 at 49-51, 55-56.

In short, even if FERC had the authority to allow unjust and unreasonable contracts in order to promote its policy preference for market solutions—and it clearly does not—there is no basis for petitioners' parade of horribles concerning the need for contract certainty. FERC can and should provide relief in this case while making clear that contract rates will be considered presumptively reasonable absent highly unusual circumstances. Petitioners' contrary claim that contract rates must be upheld in all circumstances should be addressed to Congress. For the Court to "step outside its role in construing this statute, and insert itself into the debate on economics and the public interest, would be an unwarranted intrusion into the legislative forum." *Texaco*, 417 U.S. at 401; *see also Hope*, 320 U.S. at 614.

CONCLUSION

The Court should affirm the judgment of the court of appeals.

Respectfully submitted.

RICHARD G. TARANTO
FARR & TARANTO
1220 19th Street, N.W.
Washington, DC 20036
Counsel for Nevada Power Co. and Sierra Pacific Power Co.

PAUL J. KALETA
NEVADA POWER COMPANY
6226 West Sahara Ave.
Las Vegas, NV 89151

ROGER BERLINER
BERLINER LAW PLLC
700 12th Street, N.W.
Washington, DC 20005
Counsel for Nevada Power Co. and Sierra Pacific Power Co.

ERIC P. WITKOSKI
OFFICE OF THE NEVADA ATTORNEY GENERAL
BUREAU OF CONSUMER PROTECTION
555 E. Washington Ave. #3900
Las Vegas, NV 89101

CHRISTOPHER J. WRIGHT*
HARRIS, WILTSHIRE & GRANNIS LLP
1200 18th Street, N.W.
Washington, DC 20036
(202) 730-1300
Counsel for Snohomish County PUD No. 1

* *COUNSEL OF RECORD*

ERIC CHRISTENSEN
SNOHOMISH COUNTY PUD NO. 1
2320 California Street
Everett, WA 98201

JOHN E. MCCAFFREY
DAVID D'ALESSANDRO
KELLY A. DALY
STINSON MORRISON HECKER LLP
1150 18th Street, N.W., Ste. 800
Washington, DC 20036
Counsel for the Office of the Nevada Attorney General Bureau of Consumer Protection

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